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SMALL BUSINESS ADMINISTRATION

13 CFR Part 120

RIN 3245-AG97

Streamlining and Modernizing Certified Development Company Program (504 Loan Program) Corporate Governance Requirements

AGENCY: U.S. Small Business Administration.

ACTION: Proposed rule.

SUMMARY: This rule proposes to streamline and update the operational and organizational requirements for Certified Development Companies (CDCs) in order to improve efficiencies and reduce costs without unduly increasing risk in the 504 Loan Program. The proposed changes include streamlining the requirements that would apply to the corporate governance of CDCs, and updating the requirements that would apply to professional services contracts entered into by CDCs, the requirements related to the audit and review of a CDC's financial statements, and the requirements related to the balance that a PCLP CDC must maintain in its Loan Loss Reserve Fund.

DATES: The U.S. Small Business Administration (SBA) must receive comments on this proposed rule on or before [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN FEDERAL REGISTER].

ADDRESSES: You may submit comments, identified by RIN: 3245-AG97, by any of the following methods:

- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.

- Mail: Linda Reilly, Chief, 504 Program Branch, Office of Financial Assistance, Small Business Administration, 409 3rd Street, SW, Washington, DC 20416.
- Hand Delivery/Courier: Linda Reilly, Chief, 504 Program Branch, Office of Financial Assistance, Small Business Administration, 409 3rd Street, SW, Washington, DC 20416.

SBA will post all comments on <http://www.regulations.gov>. If you wish to submit confidential business information (CBI) as defined in the User Notice at <http://www.regulations.gov>, please submit the information to Linda Reilly, Chief, 504 Program Branch, Office of Financial Assistance, Small Business Administration, 409 3rd Street, SW, Washington, DC 20416. Highlight the information that you consider to be CBI and explain why you believe SBA should hold this information as confidential. SBA will review the information and make the final determination whether it will publish the information.

FOR FURTHER INFORMATION CONTACT: Linda Reilly, Chief, 504 Program Branch, Office of Financial Assistance, Small Business Administration, 409 3rd Street, SW, Washington, DC 20416; telephone: 202-205-9949; email: linda.reilly@sba.gov.

SUPPLEMENTARY INFORMATION:

I. Background

The 504 Loan Program is an SBA financing program authorized under Title V of the Small Business Investment Act of 1958, 15 U.S.C. 695 et seq. The core mission of the 504 Loan Program is to provide long-term financing to small businesses for the purchase or improvement of land, buildings, and major equipment in an effort to facilitate the creation or retention of jobs and local economic development. Under the 504 Loan

Program, loans are made to small businesses by Certified Development Companies (CDCs), which are certified and regulated by SBA to promote economic development within their community. In general, a project in the 504 Loan Program (a 504 Project) is financed with: a loan obtained from a private sector lender with a senior lien covering at least 50 percent of the project cost (the Third Party Loan); a loan obtained from a CDC (the 504 Loan) with a junior lien covering up to 40 percent of the total cost (backed by a 100 percent SBA-guaranteed debenture sold in private pooling transactions); and a contribution from the Borrower of at least 10 percent equity.

II. Proposed Changes to CDC Operational and Organizational Requirements

SBA is proposing to simplify, streamline, and update SBA's regulations relating to CDC operational and organizational requirements in order to improve efficiencies and achieve cost savings without compromising performance in the 504 Loan Program. To accomplish this goal, SBA proposes to amend the following sections in 13 CFR part 120:

A. Section 120.818 Applicability to existing for-profit CDCs.

Prior to 2014, 13 CFR 120.822 required CDCs to have a membership consisting of at least 25 members. This provision also provided that "no person or entity can own or control more than 10 percent of the CDC's voting membership (or stock)." When SBA removed the CDC membership requirement in 2014, the prohibition against any person or entity owning or controlling more than 10 percent of a for-profit CDC's voting stock was inadvertently eliminated. See 79 FR 15641 (March 21, 2014). SBA is proposing to reinstate this provision by adding it to § 120.818. The purpose of the 10 percent limit on stock ownership is to ensure that no one person or entity can control a for-profit CDC.

B. Section 120.823 CDC Board of Directors.

SBA proposes to amend § 120.823(a) by lowering the minimum number of directors required for the CDC's Board from nine (9) to seven (7). To satisfy SBA's quorum requirements set forth in § 120.823(c)(2), a Board with nine directors must have at least five directors present in order to hold a meeting. SBA is aware of the difficulty that some small and mid-sized CDCs have in satisfying the quorum requirements for Board meetings based on a nine-member Board. Although CDCs may, under the current rule, request that SBA approve a Board with fewer members than nine for good cause, SBA has decided to reduce the required minimum number of Board members to seven, which will lower the number of members needed for a quorum from five to four. SBA has also determined that each CDC should be permitted to determine the maximum number of members on its Board and is, therefore, proposing to remove the recommendation in § 120.823(a) that a CDC have no more than 25 voting Directors on the Board. For consistency, SBA is proposing to reduce the number of members needed for a quorum of the CDC's Loan Committee under § 120.823(d)(4)(ii)(B) from five to four.

SBA is also proposing to insert language in §120.823(a) to make it clear that Board members are required to live or work in the CDC's Area of Operations. Historically, SBA interpreted former § 120.822(b) (*see, e.g.*, 13 CFR 120.822(b)(2013)) to require CDC Board members to live or work in the CDC's Area of Operations. However, the regulatory text supporting this interpretation was removed when the CDC membership requirement set forth in § 120.822 was removed in 2014. See 79 FR 15641 (March 21, 2014). SBA notes that, with certain exceptions, the current regulations require Loan Committee members to live or work in the Area of Operations of the State

where the 504 Project they are voting on is located. To be consistent, SBA is proposing to revise the regulations to expressly apply this requirement, with a slight modification in the wording (explained below), to Board members as well since the Board is required to vote on projects greater than \$2 million and, if no Loan Committee is established, on projects less than \$2 million.

In addition, the intent of this requirement – that Board members have a local connection to the area in which the CDC operates – would also be served by allowing Board members to live or work in an area that, although not in the CDC’s Area of Operations, is contiguous to the Area and meets the definition in § 120.802 of a Local Economic Area (LEA) for the CDC, such as a metropolitan statistical area that is bisected by a State line. SBA is therefore proposing to amend § 120.823(a) to allow Board members to satisfy the “work or live in” requirement in this manner. For consistency, SBA is proposing to amend § 120.823(d)(4)(ii)(E) to allow Loan Committee members to satisfy the “work or live in” requirement by working or living in an area that meets the definition of an LEA as well.

SBA is also proposing to simplify the phrase “live or work in the Area of Operations of the State where the 504 project they are voting on is located”. Today, the minimum Area of Operations for each CDC is the State in which the CDC is incorporated. *See* § 120.802 (Definition of “Area of Operations”). It would, therefore, be simpler to replace this phrase with “live or work in the CDC’s State of incorporation”.

In addition, SBA proposes to delete the requirement in § 120.823(a) that requires CDCs to have at least one voting director who represents the economic, community, or workforce development fields. By removing this requirement, SBA is clarifying that a

CDC need not appoint a director who has expertise only in the economic, community, or workforce development fields. Instead, SBA is proposing to add “the economic, community, or workforce development fields” to the other areas of expertise identified in the current § 120.823(a) that must be represented on the Board. The five other areas of expertise that must be represented on the Board include internal controls, financial risk management, commercial lending, legal issues relating to commercial lending, and corporate governance. For purposes of complying with the representational requirements in § 120.823(a), one director may have more than one area of expertise.

SBA is also proposing to remove the requirement in § 120.823(c)(4) that limits the number of directors in the commercial lending field to less than 50% of the Board of Directors. With this change, SBA would allow CDCs to determine the number of directors on the Board who have a commercial lending background. By requiring that the Board include members with background and expertise in the six identified areas, SBA believes that proposed § 120.823(a) would ensure an appropriate level of diversity of experience on the Board.

C. Section 120.824 Professional management and staff.

1. Professional Services Contracts between CDCs

A CDC may currently obtain, under a written contract that is pre-approved by SBA, services from qualified individuals and entities to perform management, marketing, packaging, processing, closing, servicing, or liquidation functions in accordance with the requirements set forth in § 120.824(a) through (f). Known as professional services contracts, a few CDCs have contracted with other CDCs to obtain assistance under this provision (although none are obtaining management services from another CDC). The

type of relationship that may be created between CDCs through these contracts is limited by § 120.820(d), which prohibits a CDC from affiliating (as determined in accordance with 13 CFR 121.103) with another CDC.

SBA believes that some smaller CDCs may benefit from the assistance available from their larger counterparts that operate in the same SBA Region or in contiguous States, and SBA is proposing to permit a CDC to enter into a professional services contract with another CDC under certain conditions, even if the arrangement would give rise to an affiliation between the CDCs based on an “identity of interest”, as defined under 13 CFR 121.103(f).¹ With this rulemaking, SBA is proposing to establish the conditions under which a CDC may contract with another CDC for marketing, packaging, processing, closing, servicing, or liquidation functions. Specifically, SBA proposes to incorporate the existing provisions of § 120.824(a) through (f) into a new paragraph (a), which would address professional services contracts generally (*i.e.*, between a CDC and any third party), and is proposing the following conditions as a new paragraph (b), which would specifically address professional services contracts between CDCs:

(a) Prior Approval of Contracts

The contract between the CDCs for marketing, packaging, processing, closing, servicing, or liquidation functions must be pre-approved by the Director of the Office of Financial Assistance (D/FA) (or designee), in consultation with the Director of the Office of Credit Risk Management (D/OCRM) (or designee), who will determine in his or her

¹ Under 13 CFR 121.103(f), an identity of interest is created when the CDCs have identical or substantially identical business or economic interests or are economically dependent through contractual or other relationships. For example, under § 121.103(f), if all or most of the CDC’s key functions (including 504 and non-504 functions in the aggregate) are performed by staff that is obtained under contract with another CDC, the two CDCs may be affiliated based on an identity of interest.

discretion that such approval is in the best interests of the 504 Loan Program and that the contract includes terms and conditions satisfactory to SBA.

SBA notes that, generally, a CDC is required under the current § 120.824(a) (to be redesignated as § 120.824(a)(1)) to have at least one salaried professional that is employed directly by the CDC as its full time manager. Currently, a CDC may seek a waiver of this requirement and SBA's prior approval of a contract for management services from another CDC only if the CDC in need of management services is located in a rural area and satisfies the other conditions for a waiver of the management requirement, as set forth in the current § 120.824(a)(2) (to be redesignated as § 120.824(a)(1)(ii)). This proposed rule would not change these provisions, except that SBA proposes to require that a rural CDC's contract for management services must be pre-approved by the D/FA (or designee) in consultation with the D/OCRM (or designee), instead of pre-approved by the D/FA only.

SBA also notes that a CDC may petition for a waiver of the management requirement under the current § 120.824(a)(1) (to be redesignated as § 120.824(a)(1)(i)) to obtain management services from another non-profit entity under certain conditions. SBA has interpreted this provision to mean that the other non-profit entity may not be another CDC. To make this clear, SBA is proposing to expressly state in the redesignated § 120.824(a)(1)(i) that the non-profit entity from which a CDC may obtain management services cannot be another CDC. The proposed rule would continue to require that the contract and request for waiver must be pre-approved by the D/FA (or designee), but it would add that this approval must be done in consultation with the D/OCRM (or designee).

(b) CDCs Must Be Located in Same SBA Region or Contiguous States

The CDCs entering into the contract must be located either in the same SBA Region or, if not in the same SBA Region, must be located in contiguous States. For purposes of this provision, the location of a CDC is the CDC's State of incorporation. SBA does not want a CDC to be able to use professional services contracts with other CDCs as a means to establish a presence outside of its home SBA Region or a contiguous State. This is consistent with the history and purpose of the program as a local development program, where CDCs are closely tied to the localities in which they lend and perform other economic development activities. For any CDC that currently provides services under contract to another CDC outside the allowed areas, the CDCs would be permitted to continue the contract until the term of the current contract expires.

(c) Assistance May Be Provided to Only One CDC Per State

A CDC may provide assistance to only one CDC per State. SBA does not want any one CDC to be able to use professional services contracts with other CDCs in a way that discourages new CDCs from forming in a State or that is detrimental to the viability of existing CDCs in the State.

(d) Other Geographic Limits on Where CDCs May Provide Assistance

No CDC may provide assistance to another CDC in its State of incorporation or in any State in which the CDC has Multi-State authority. Again, SBA does not want any one CDC to be able to use professional services contracts with other CDCs in a way that discourages new CDCs from forming in a State or that is detrimental to the viability of existing CDCs in the State. SBA would also like to solicit comments from the public on whether SBA should place any limitations on the ability of a CDC that has expanded its

operations into a Local Economic Area to provide assistance to another CDC that operates in the LEA.

(e) Independent CDCs

The Board of Directors for each CDC entering into the contract must be separate and independent and may not include any common directors, whether voting or non-voting. In addition, if either of the CDCs is for-profit, neither CDC may own any stock in the other CDC (notwithstanding § 120.820(d), which allows a CDC to invest in or finance another CDC with the prior written approval of SBA officials). SBA wants the CDCs to retain the independence and control provided by separate Boards and does not want a CDC to be able to exercise any degree of control over another CDC through any ownership interest in the other CDC. In addition, the CDCs are prohibited from comingling any funds.

(f) Other Requirements that Apply to These Contracts

The CDCs and the contract must comply with the other requirements for professional services contracts set forth in proposed § 120.824(a). A contract between CDCs may not include either services for independent loan reviews or management services (except for rural CDCs as provided in accordance with redesignated § 120.824(a)(1)(ii)). In addition, affiliation between CDCs based on grounds other than identity of interest, including but not limited to through common management or ownership under § 121.103(c) and (d), respectively, would continue to be prohibited.

2. Other Changes that Would Apply to All Professional Services Contracts

SBA proposes to incorporate the provisions currently set forth in 13 CFR 120.824(a) through (f) into a new paragraph (a) that would apply to all professional

services contracts (including professional services contracts between CDCs) with the following changes:

(a) Contracts Requiring Prior Approval

The types of contracts that a CDC may enter into, with SBA's prior approval, are listed in current § 120.824(b), and include contracts for assistance in management, marketing, packaging, processing, closing, servicing, or liquidation functions. SBA wants to clarify in this rule that the CDC must obtain SBA's prior approval of co-employment contracts that a CDC wants to enter into with a third party, such as a professional employer organization, to obtain employee benefits, such as retirement and health benefits, on a more cost-effective basis for the CDC's staff. The contracts that some CDCs have submitted to SBA for prior approval have provided that the CDC's staff were deemed to be the co-employees of both the CDC and the contractor. SBA wants CDCs and their staff to be able to obtain the cost savings and benefits that can be obtained under these types of contracts, but wants to ensure that the contract provides that the CDC retains the final authority to hire and fire the CDC's staff.

In addition, under the current regulation, CDCs may contract for legal and accounting services without SBA approval, except for legal services in connection with loan liquidation or litigation. SBA is proposing to include services for information technology and independent loan reviews in the types of contracts listed in current 120.824(b) (to be redesignated as § 120.824(a)(2)) that CDCs may enter into without obtaining prior SBA approval. As indicated in section II.C.1(f) above, however, CDCs may not contract with other CDCs for the performance of independent loan reviews.

(b) Other Clarifying and Technical Changes

Under the current § 120.824(e)(1), the CDC’s Board must demonstrate to SBA that “the compensation under the [professional services] contract is only from the CDC”. For clarity, SBA is proposing to revise this provision (to be redesignated as § 120.824(a)(3)(i)) to state that “the compensation under the contract is paid only by the CDC.” In addition, in the current § 120.824(e)(3), the CDC’s Board must demonstrate that the contracts do not “evidence” any actual or apparent conflict of interest or self-dealing. For clarity, SBA is proposing to revise this provision (to be redesignated as § 120.824(a)(3)(iii)) to require the Board to demonstrate that there is no actual or apparent conflict of interest or self-dealing in the negotiation, approval or implementation of the contract.

In addition, under the current § 120.824(d), the CDC must provide copies of these contracts to SBA for review annually. SBA is proposing to revise this provision (to be redesignated as § 120.824(a)(5)) to clarify that the CDC procuring the services must provide a copy of all executed contracts to SBA as part of the CDC’s Annual Report submitted under § 120.830(a) unless the CDC certifies that it has previously submitted an identical copy of the contract to SBA.

Another change being proposed concerns the current § 120.824(c), under which the contracts must clearly identify terms and conditions satisfactory to SBA that permit the CDC to terminate the contract prior to its expiration date on a reasonable basis. To give CDCs procuring services maximum flexibility, SBA is proposing to revise the standard under which the CDC procuring the services may terminate the contract to “with or without cause”. SBA is proposing to add this requirement to the current § 120.824(e)(2) (to be redesignated as § 120.824(a)(3)(ii)).

Finally, under the current § 120.824(f), no contractor or Associate of a contractor may be a voting or non-voting member of the CDC's Board. The term "Associate" is generally defined in § 120.10 with respect to a lender, CDC or small business, but not with respect to a contractor of a CDC. SBA is proposing therefore to replace the phrase "Associate of a contractor" with text that is consistent with the definition of Associate in § 120.10.

D. Section 120.826 Basic requirements for operating a CDC.

Under the current § 120.826(c), each CDC with a 504 loan portfolio balance of \$20 million or more must have its financial statements audited annually by a certified public accountant (CPA) that is independent and experienced in auditing financial institutions, and each CDC with a 504 loan portfolio balance of less than \$20 million must have its financial statements reviewed annually. SBA is proposing to revise this paragraph by increasing the dollar threshold that would trigger an annual audit requirement of the CDC's financial statements from \$20 million to \$30 million. For loan portfolio balances of less than \$30 million, the CDC's financial statements would be required to be reviewed by an independent CPA in accordance with generally accepted accounting principles (GAAP). However, under the proposed change, a CDC with a portfolio balance of less than \$30 million may be required to provide audited financial statements at the discretion of the D/OCRM when the CDC is in material noncompliance with SBA's Loan Program Requirements (defined in § 120.10), such as with requirements related to financial solvency or business integrity. SBA notes that CDCs that participate in other SBA programs, such as the Community Advantage Pilot Loan

Program or the Microloan Program, must continue to comply with the audit requirements of those other SBA programs.

There are currently 19 CDCs (about 9% of all CDCs) with portfolio balances of at least \$20 million but less than \$30 million. By increasing the dollar threshold for audited financial statements to \$30 million, these 19 CDCs would save the difference in cost between an audited and a reviewed financial statement, which SBA estimates to be \$15,000 annually for each CDC, without unduly increasing risk. There are currently 60 CDCs (about 28% of all CDCs) with portfolio balances under \$20 million. Therefore, a total of 79 CDCs (about 37% of all CDCs) would not be required to provide audited financial statements unless, as noted above, circumstances warrant.

E. Section 120.835 Application to expand an Area of Operations.

Under the current § 120.835(c), a CDC is required to establish a separate Loan Committee in each State into which it expands as a Multi-State CDC and all of the members of that Loan Committee must live or work in the State into which the CDC expands. SBA is proposing to amend paragraph (c) of § 120.835 to offer the following alternative to establishing a Loan Committee in each such additional State: if the CDC has established a Loan Committee in its State of incorporation, then when voting on a Project in the additional State, the CDC may include at least two individuals who live or work in that State on the CDC's Loan Committee. To make it clear that the two individuals added to the Loan Committee may vote only on the Projects located in the additional State into which the CDC expands and would not be eligible to participate in voting on Projects in any other State, SBA is proposing to add the term "only" after "[c]onsist" in § 120.823(d)(4)(ii)(E). If the CDC has not established a Loan Committee in

its State of incorporation, the alternative would require that at least two individuals who live or work in the additional State be included on the CDC's Board of Directors when voting on a Project in that State.

This alternative to the separate Loan Committee requirement would reduce the time and expense that a CDC incurs in establishing and maintaining a separate Loan Committee in each State into which it expands, while still requiring a local connection when the Board or its Loan Committee votes on these Multi-State projects. With this change, Multi-State CDCs would have an alternative to establishing a separate Loan Committee in each State in which they operate.

If the proposed revision to § 120.835(c) discussed in the preceding two paragraphs is adopted, it will be necessary to make a conforming change to the current § 120.823(d)(4)(ii)(E). In addition, as noted above in section II.B, SBA is proposing to simplify the phrase in the current regulation that members must "live or work in the Area of Operations of the State where the 504 project they are voting on is located". As noted above, the minimum Area of Operations is the State in which the CDC is incorporated. It would, therefore, be simpler to replace this phrase with "live or work in the CDC's State of incorporation". In addition, with this change, it would no longer be necessary to provide an exception in § 120.823(d)(4)(ii)(E) for projects that "fall[] under one of the exceptions listed in § 120.839". Under the proposed revision, the CDC's Loan Committee established under § 120.823(d)(4)(ii)(E) would be able to approve projects that fall under § 120.839 and SBA is, therefore, proposing to remove the reference to § 120.839.

F. Section 120.839 Case-by-case application to make a 504 loan outside of a CDC's Area of Operations.

Section 120.839 currently permits a CDC to make a 504 loan outside of a CDC's Area of Operations if certain conditions are satisfied, including that the CDC has previously assisted the business to obtain a 504 loan. SBA is proposing to expand paragraph (a) of this section to allow a CDC to apply to make a 504 loan outside its Area of Operations if the CDC has previously assisted either the business "or its affiliate(s)." SBA believes that, if the CDC had previously assisted an affiliate of the business, the CDC would have sufficient familiarity with the business' management and credit risk to prudently assist the business.

G. Section 120.847 Requirements for the Loan Loss Reserve Fund (LLRF).

Currently, CDCs that participate in the Premier Certified Lenders Program (PCLP CDCs) are required to establish and maintain an LLRF in an amount equal to one percent of the original principal amount of the PCLP Debentures issued by the CDC. The amount maintained in the LLRF for each PCLP Debenture remains the same even as the principal balance of the Debenture is paid down over time.

SBA is proposing to revise paragraph (b) of this section to allow PCLP CDCs to maintain a balance in the LLRF equal to one percent of the current principal amount, instead of the original principal amount, of the PCLP Debenture after the loan is seasoned for 10 years. However, a CDC may not use the declining balance methodology: (1) with respect to any PCLP Debenture that has been purchased, in which case the CDC must restore the balance maintained in the LLRF with respect to that Debenture to one percent of the original principal amount within 30 days after purchase; or (2) with respect to any

other PCLP Debenture if SBA notifies the CDC in writing that it has failed to satisfy the requirements in paragraphs (e), (f), (h), (i) and (j) of § 120.847. In the latter case, the CDC will not be required to restore the balance maintained in the LLRF to one percent of the original principal amount of the Debenture but must base the amount maintained in the LLRF on one percent of the principal amount of the Debenture as of the date of notification. The CDC may not begin to use the declining balance methodology again until SBA notifies the CDC in writing that SBA has determined, in its discretion, that the CDC has corrected the noncompliance and has demonstrated its ability to comply with these requirements.

For example, if a CDC fails to timely submit one or more periodic loan loss reserve reports under § 120.847(f) (which are required to be submitted on a quarterly basis pursuant to SBA Form 2233), SBA would notify the CDC that it may no longer use the declining balance methodology. The CDC would not be required to restore the balance maintained in the LLRF to one percent of the original principal amount of the Debenture, but would be required to maintain an amount based on one percent of the principal amount of the Debenture as of the date of notification. Upon the CDC's submission of the delinquent report(s), SBA would notify the CDC that it may again use the declining balance methodology based on the original principal amount if SBA determines the CDC is able to comply with the reporting requirement going forward.

By allowing PCLP CDCs to utilize a declining balance methodology for each Debenture that is at least 10 years old, more cash would be available to support the CDC's operations or to invest in other economic development activities without unduly increasing risk. All withdrawals must be made in accordance with the requirements of §

120.847(g). This provision currently requires the CDC to forward requests for withdrawals to the Lead SBA Office, but SBA is proposing to change the official to whom withdrawal requests should be forwarded to the D/OCRM (or designee). If the change in permitted use of the declining balance methodology is adopted, SBA will monitor whether the adequacy of the CDC's LLRF is affected.

III. Compliance with Executive Orders 12866, 13563, 12988, 13771, and 13132, the Paperwork Reduction Act (44 U.S.C. Ch. 35), and the Regulatory Flexibility Act (5 U.S.C. 601–612).

Executive Order 12866

The Office of Management and Budget (OMB) has determined that this proposed rule is not a “significant” regulatory action for the purposes of Executive Order 12866. In addition, this is not a major rule under the Congressional Review Act, 5 U.S.C. 800.

Executive Order 13563

The agency coordinated outreach efforts to engage stakeholders before proposing this rule. The 504 Loan Program operates through the agency's lending partners, which for this program are CDCs. The agency has participated in lender conferences and trade association meetings and received feedback from CDCs, a trade association, and third-party lenders that provided valuable insight to SBA.

Executive Order 13771

This proposed rule is not expected to be an EO 13771 regulatory action because this proposed rule is not significant under EO 12866.

Executive Order 12988

This action meets applicable standards set forth in Sections 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden. The action does not have retroactive or preemptive effect.

Executive Order 13132

SBA has determined that this proposed rule will not have substantial, direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Therefore, for the purposes of Executive Order 13132, SBA has determined that this proposed rule has no federalism implications warranting preparation of a federalism assessment.

Paperwork Reduction Act, 44 U.S.C., Ch. 35

SBA has determined that this proposed rule would require that SBA Form 1253, Certified Development Company (CDC) Annual Report Guide (OMB Approval 3245-0074), be revised to clarify or add information that CDCs are required to submit with their Annual Report. With respect to the Financial Report (Tab 3) of the form, a CDC is currently allowed to submit a reviewed financial statement instead of an audited financial statement if it has a 504 loan portfolio balance of less than \$20 million. This proposed rule would raise this threshold to \$30 million and, if adopted, it will be necessary to revise the instruction in the form accordingly. The substance of the information that would be collected is not being changed, only that fewer CDCs would need to submit it.

In addition, with respect to the Operating Report (Tab 2) of SBA Form 1253, the CDC is currently required to submit a copy of all contracts for management and/or staff in place during the reporting period. The types of contracts in question, as currently

described in the regulations (*e.g.*, managing, marketing, servicing, etc.), are the same contracts that must be submitted to SBA for pre-approval; however, the list does not specifically identify co-employment contracts under which a third party (such as a professional employer organization) is responsible for the management and administration of certain employment benefits, such as retirement and health benefits. Accordingly, the form would be changed to clarify that SBA must pre-approve these contracts.

SBA has also determined that, as currently written, the requirement to submit a copy of all contracts with the Annual Report could result in duplicative reporting since CDCs should have provided SBA with an executed copy of any contract after obtaining SBA's prior approval. As a result, SBA is proposing to revise this requirement to make it clear that CDCs would no longer be required to submit a copy of its contracts with the Annual Report if a copy of the current and executed contract has been previously submitted to SBA. The CDC would be required to provide a certification with its Annual Report that it has previously submitted a copy of the executed contract to SBA and that no changes have been made to it. The certification would also need to state to whom and on what date the contract was provided to SBA.

Another form that would require a change as a result of this proposed rule is SBA Form 2233, Premier Certified Lenders Program (PCLP), Quarterly Loan Loss Reserve Report (OMB Approval 3245-0346). This form instructs the PCLP CDC to submit the completed form to the "Lead SBA Office". This proposed rule would change the office to which this form is submitted to the "Office of Credit Risk Management", and this form would be revised accordingly.

SBA invites comments on the proposed changes to the underlying regulations that would impact these forms by the deadline for comments noted in the DATES section. SBA has determined that the changes proposed for the forms described above are not substantive in nature and do not need to be submitted to OMB for approval.

Regulatory Flexibility Act, 5 U.S.C. 601-612

When an agency issues a rulemaking, the Regulatory Flexibility Act (RFA), 5 U.S.C. 601-612, requires the agency to “prepare and make available for public comment an initial regulatory analysis” which will “describe the impact of the proposed rule on small entities.” Section 605 of the RFA allows an agency to certify a rule, in lieu of preparing an analysis, if the proposed rulemaking is not expected to have a significant economic impact on a substantial number of small entities. Although the rulemaking will impact all 215 CDCs (all of which are small), SBA does not believe the impact will be significant. As stated above, the proposed rule will streamline the operational and organizational requirements that CDCs must satisfy and reduce their costs, and therefore will not increase their burden.

For example, under the proposed rule, the 19 CDCs that currently have 504 loan portfolio balances between \$20 million and \$30 million would no longer be required to provide audited financial statements, but may submit reviewed financial statements instead. As noted above, SBA estimates that the elimination of the audited review for these CDCs will save each CDC approximately \$15,000 per year.

In addition, SBA is proposing to reduce the regulatory requirements imposed on CDCs related to corporate governance. For example, SBA is proposing to decrease the number of members that a CDC is required to appoint to its Board of Directors from nine

to seven. This change would also make it easier for a CDC to meet the quorum requirements for conducting its business. SBA is also proposing to expand the area in which Board and Loan Committee members may work or live; remove the limit on the number of members that may serve on the Board from the commercial lending fields; allow CDCs in need of assistance to contract for services with another CDC under certain circumstances even if the CDCs would become affiliated as a result; eliminate the requirement that CDCs establish a separate Loan Committee in each State into which the CDC expands as a Multi-State CDC; and expand the criteria under which a CDC may make a 504 loan outside its Area of Operations.

Another significant change being proposed is the reduction in the amount that PCLP CDCs need to maintain in the Loan Loss Reserve Fund. By allowing PCLP CDCs to utilize a declining balance methodology for the LLRF after a Debenture has been outstanding for 10 years, more cash would be available to support the CDC's operations or to invest in other economic development activities without unduly increasing risk.

SBA believes that this rule is SBA's best available means for facilitating American job preservation and creation by removing unnecessary regulatory requirements. Since the main purpose of this proposed rule is to reduce unnecessary regulatory burdens, a review of the preamble sections above will provide additional detailed explanations regarding how and why this proposed rule will reduce regulatory burdens and responsibly increase program participation flexibility. For these reasons, SBA has determined that there is no significant impact on a substantial number of small entities.

List of Subjects in 13 CFR Part 120

Community development, Equal employment opportunity, Loan programs—
business, Reporting and recordkeeping requirements, Small business.

For the reasons stated in the preamble, SBA proposes to amend 13 CFR part 120 as follows:

PART 120 - BUSINESS LOANS

1. The authority for 13 CFR part 120 continues to read as follows:

Authority: 15 U.S.C. 634(b)(6), (b)(7), (b)(14), (h) and note, 636(a), (h) and (m), 650, 687(f), 696(3) and (7), and 697(a) and (e); Pub. L. 111-5, 123 Stat. 115, Pub. L. 111-240, 124 Stat. 2504.

2. Amend § 120.818 by designating the undesignated paragraph as paragraph (a) and adding paragraph (b) to read as follows:

§ 120.818 Applicability to existing for-profit CDCs.

* * * * *

(b) No person or entity can own or control more than 10 percent of a for-profit CDC's stock.

3. Amend § 120.823 by:

- a. Revising paragraph (a);
- b. Adding the word “and” at the end of paragraph (c)(3);
- c. Removing paragraph (c)(4) and redesignating paragraph (c)(5) as paragraph (c)(4); and
- d. Revising paragraphs (d)(4)(ii)(B) and (E).

The revisions read as follows:

§ 120.823 CDC Board of Directors.

(a) The CDC, whether for-profit or nonprofit, must have a Board of Directors with at least seven (7) voting directors who live or work in the CDC's State of incorporation or in an area that is contiguous to that State that meets the definition of a Local Economic Area for the CDC. The Board must be actively involved in encouraging economic development in the Area of Operations. The initial Board may be created by any method permitted by applicable State law. At a minimum, the Board must have directors with background and expertise in internal controls, financial risk management, commercial lending, legal issues relating to commercial lending, corporate governance, and economic, community or workforce development. Directors may be either currently employed or retired.

* * * * *

(d) * * *

(4) * * *

(ii) * * *

(B) Have a quorum of at least four (4) Loan Committee members authorized to vote;

* * * * *

(E) Consist only of Loan Committee members who live or work in the CDC's State of incorporation or in an area that meets the definition of a Local Economic Area for the CDC, except that, for Projects that are financed under a CDC's Multi-State authority, the CDC must satisfy the requirements of either § 120.835(c)(1) or (2) when voting on that Project.

* * * * *

4. Revise § 120.824 to read as follows:

§ 120.824 Professional management and staff.

A CDC must have full-time professional management, including an Executive Director (or the equivalent) to manage daily operations. It must also have a full-time professional staff qualified by training and experience to market the 504 Loan Program, package and process loan applications, close loans, service, and, if authorized by SBA, liquidate the loan portfolio, and to sustain a sufficient level of service and activity in the Area of Operations.

(a) Professional services contracts. Through a written contract with qualified individuals or entities, a CDC may obtain services for management, marketing, packaging, processing, closing, servicing, or liquidation functions, provided that:

(1) The CDC must have at least one salaried professional employee that is employed directly (not a contractor or an officer, director, 20% or more equity owner, or key employee of a contractor) on a full-time basis to manage the CDC. The CDC manager must be hired by the CDC's Board of Directors and subject to termination only by the Board. A CDC may petition SBA to waive the requirement of the manager being employed directly by the CDC if:

(i) Another non-profit entity (that is not a CDC) that has the economic development of the CDC's Area of Operations as one of its principal activities will provide management services to the CDC and, if the manager is also performing services for the non-profit entity, the manager will be available to small businesses interested in the 504 program and to 504 loan borrowers during regular business hours; or

(ii) The CDC petitioning SBA for such waiver is rural, has insufficient loan volume to justify having management employed directly by the CDC, and is requesting to contract with another CDC located in the same general area to provide the management.

(2) The contract must be pre-approved by the D/FA (or designee), except that with respect to contracts for management services and requests for waivers under paragraph (a)(1) of this section, the contract and request for waiver must be pre-approved by the D/FA (or designee) in consultation with the D/OCRM (or designee). With respect to any contract under which the CDC's staff are deemed co-employees of both the CDC and the contractor (*e.g.*, contracts with professional employer organizations to obtain employee benefits, such as retirement and health benefits, for the CDC's staff), the contract must provide that the CDC retains the final authority to hire and fire the CDC's employees. (CDCs may contract for legal, accounting, information technology, and independent loan review services without SBA approval, except for legal services in connection loan liquidation or litigation. In addition, a CDC may not contract with another CDC for independent loan review services.)

(3) If a CDC's Board believes that it is in the best interest of the CDC to obtain services under paragraph (a) of this section, the CDC's Board must explain its reasoning to SBA. The CDC's Board must demonstrate to SBA that:

(i) The compensation under the contract is paid only by the CDC obtaining the service, is reasonable and customary for similar services in the Area of Operations, and is only for actual services performed;

(ii) The full term of the contract (including options) is necessary and appropriate and the contract permits the CDC procuring the services to terminate the contract prior to its expiration date with or without cause; and

(iii) There is no actual or apparent conflict of interest of self-dealing on the part of any of the CDC's officers, management, and staff, including members of the Board and Loan Committee, in the negotiation, approval or implementation of the contract.

(4) Neither the contractor nor any officer, director, 20% or more equity owner, or key employee of a contractor may be a voting or non-voting member of the CDC's Board.

(5) The CDC procuring the services must provide a copy of all executed contracts to SBA as part of the CDC's Annual Report submitted under § 120.830(a) unless the CDC certifies that it has previously submitted an identical copy of the executed contract to SBA.

(6) If the contract is between CDCs, the CDCs and the contract must comply with paragraph (b) of this section, and the contract may not include management services (except in accordance with paragraph (a)(1)(ii) of this section) or services for independent loan reviews.

(b) Professional services contracts between CDCs. Notwithstanding the prohibition in § 120.820(d) against a CDC affiliating with another CDC, a CDC may obtain services through a written contract with another CDC for marketing, packaging, processing, closing, servicing, or liquidation functions, provided that:

(1) The contract between the CDCs must be pre-approved by the D/FA (or designee), in consultation with the D/OCRM (or designee), who determines in his or her

discretion that such approval is in the best interests of the 504 Loan Program and that the terms and conditions of the contract are satisfactory to SBA. A CDC may contract with another CDC for a management function only in accordance with paragraph (a)(1)(ii) of this section.

(2) The CDCs entering into the contract must be located in the same SBA Region or, if not located in the same SBA Region, must be located in contiguous States. For purposes of this paragraph (b)(2), the location of a CDC is the CDC's State of incorporation.

(3) A CDC may provide assistance to only one CDC per State.

(4) No CDC may provide assistance to another CDC in its State of incorporation or in any State in which the CDC has Multi-State authority.

(5) The Board of Directors for each CDC entering into the contract must be separate and independent and may not include any common directors. In addition, if either of the CDCs is for-profit, neither CDC may own any stock in the other CDC. The CDCs are also prohibited from comingling any funds.

(6) The contract must satisfy the requirements set forth in paragraph (a) of this section.

§ 120.826 [Amended]

5. Amend § 120.826(c) by:

a. Removing the term "\$20 million" wherever it appears and adding the term "\$30 million" in its place;

b. Removing the period at the end of the last sentence and adding ", except that the D/OCRM may require a CDC with a portfolio balance of less than \$30 million to

submit an audited financial statement in the event the D/OCRM determines, in his or her discretion, that such audit is necessary or appropriate when the CDC is in material noncompliance with Loan Program Requirements.”

6. Amend § 120.835(c) by:

a. Adding a paragraph heading;

b. Removing the last sentence and adding the phrase “A CDC may apply to be a Multi-State CDC only if the State the CDC seeks to expand into is contiguous to the State of the CDC’s incorporation and either:” in its place; and

c. Adding paragraphs (c)(1) and (2).

The additions read as follows:

§ 120.835 Application to expand an Area of Operations.

* * * * *

(c) *Multi-State expansion.* ***

(1) The CDC establishes a Loan Committee in the additional State consisting only of members who live or work in that State and that satisfies the other requirements in § 120.823(d)(4)(ii)(A) through (D); or

(2) For any Project located in the additional State, the CDC’s Board or Loan Committee (if established in the CDC’s State of incorporation) includes at least two members who live or work in that State when voting on that Project.

§ 120.839 [Amended]

7. Amend § 120.839(a) by adding the words “or its affiliate(s)” after “business”.

8. Amend § 120.847 by:

a. Revising paragraph (b); and

b. Removing the term “Lead SBA Office” in third sentence of paragraph (g) and adding in its place “the D/OCRM (or designee)”.

The revision reads as follows:

§ 120.847 Requirements for the Loan Loss Reserve Fund (LLRF).

* * * * *

(b) *PCLP CDC Exposure and LLRF deposit requirements.* A PCLP CDC's “Exposure” is defined as its reimbursement obligation to SBA with respect to default in the payment of any PCLP Debenture. The amount of a PCLP CDC's Exposure is 10 percent of any loss (including attorney's fees; litigation costs; and care of collateral, appraisal and other liquidation costs and expenses) sustained by SBA as a result of a default in the payment of principal or interest on a PCLP Debenture. For each PCLP Debenture a PCLP CDC issues, it must establish and maintain an LLRF equal to one percent of the original principal amount of the PCLP Debenture. The amount the PCLP CDC must maintain in the LLRF for each PCLP Debenture remains the same even as the principal balance of the PCLP Debenture is paid down over time except that, after the first 10 years of the term of the Debenture, the amount maintained in the LLRF may be based on one percent of the current principal amount of the PCLP Debenture (the declining balance methodology), as determined by SBA. All withdrawals must be made in accordance with the requirements of paragraph (g) of this section. A CDC may not use the declining balance methodology:

(1) With respect to any Debenture that has been purchased. Within 30 days after purchase, the CDC must restore the balance maintained in the LLRF for the Debenture that was purchased to one percent of the original principal amount of that Debenture; or

(2) With respect to any other Debenture if SBA notifies the CDC in writing that it has failed to satisfy the requirements in paragraph (e), (f), (h), (i) or (j) of this section. In such case, the CDC will not be required to restore the balance maintained in the LLRF to one percent of the original principal amount of the Debenture but must base the amount maintained in the LLRF on one percent of the principal amount of the Debenture as of the date of notification. The CDC may not begin to use the declining balance methodology again until SBA notifies the CDC in writing that SBA has determined, in its discretion, that the CDC has corrected the noncompliance and has demonstrated its ability to comply with these requirements.

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Dated: April 5, 2019.

Linda E. McMahon,
Administrator.

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